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Supreme Court of the United States

OCTOBER TERM, 1963

No. [redacted] 183

WALTER A. SHEAFFER, II, and JOHN D. SHEAFFER, Executors of the Estate of CRAIG R. SHEAFFER, Deceased,

and

VIRGINIA D. SHEAFFER, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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vs.

COMMISSIONER OF INTERNAL REVENUE

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The following exhibits are separately certified:

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IN THE

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OCTOBER TERM, 1962

No.

WALTER A. SHEAFFER, II, and JOHN D. SHEAFFER, Executors of the Estate of CRAIG R. SHEAFFER, Deceased,

and

VIRGINIA D. SHEAFFER, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Walter A. Sheaffer, II, and John D. Sheaffer, executors of the estate of Craig R. Sheaffer, deceased, and Virginia D. Sheaffer petition for a writ of certiorari to review the decision of the United States Court of Appeals for the Eighth Circuit in this case.

OPINIONS BELOW

The opinion of the Tax Court of the United States (Appendix A, *infra*, pp. 1a-13a) is reported at 37 T.C. 99. The opinion of the United States Court of Appeals

for the Eighth Circuit (Appendix B, *infra*, pp. 14a-23a) is reported at 313 F. 2d 738.

JURISDICTION

The judgment of the United States Court of Appeals for the Eighth Circuit (Appendix C, *infra*, p. 24a) was entered on February 13, 1963. A timely application for rehearing was denied on March 6, 1963. The jurisdiction of this court is invoked under 28 U.S.C. sec. 1254(1).

QUESTION PRESENTED

Is the grantor of a trust taxable on trust income used by the trustee:

(a) To pay the gift tax resulting from the establishment of the trust; *and*

(b) To repay a loan obtained by the trustee for payment of the gift tax,—

where the gift to the trustee is subject to the trustee's prior commitment to pay the resulting gift tax?

Is the grantor thus taxable under (a) or even (b) despite the non-taxability (not controverted by the Commissioner) of such income if the grantor had made the same gifts not in trust?

STATUTES AND REGULATIONS INVOLVED

The 1939 Internal Revenue Code is applicable to the gift tax; the 1954 Code is applicable to the income tax.

The relevant provisions of the 1939 Code are:

Sec. 1000. Imposition of Tax, 53 Stat. 1, 144 as amended
Sec. 1008. Payment of Tax, 53 Stat. 1, 148
Sec. 1009. Lien for Tax, 53 Stat. 1, 149

The relevant provisions of the 1954 Code are:

Sec. 61. Gross Income Defined, 68A Stat. 1, 17
Sec. 677. Income for Benefit of Grantor, 68A Stat. 1, 230

The relevant provisions of the gift and income tax regulations are:

Treasury Regulations 108 (1939 Code)
Sec. 86.1 Imposition of Tax
Sec. 86.2 Transfers Reached
Sec. 86.34 Donor Liable For Tax
Sec. 86.35 Lien For Tax
Treasury Income Tax Regulations (1954 Code)
Sec. 1.677(a)-1. Income for Benefit of Grantor; General Rule

The foregoing sections of the statute and the regulations (or relevant portions thereof) are printed as Appendix D, *infra*, pp. 25a-30a.

STATEMENT OF THE CASE

Craig R. Sheaffer and Virginia D. Sheaffer, of Fort Madison, Iowa, were husband and wife. For the calendar years 1954 and 1955 they filed joint Federal income tax returns. On Craig's death while this case was pending in the Tax Court his estate was substituted as a party.

On February 2, 1954, Virginia D. Sheaffer created four separate trusts by a single trust instrument (Exhibit 3-C to Stipulation of Facts, T.C.R. Doc. No. 8).[1]

[1] No record was printed for the use of the Court below, which heard this case on the original Tax Court record. This reference and similar ones hereafter are to the original Tax Court record, certified by and each document numbered by the Clerk of that Court.

Harris Trust and Savings Bank of Chicago was named trustee. Each trust was for the benefit of one of her four children and his or her family. The corpus of the trust consisted of shares of common stock of W. A. Sheaffer Pen Company, Fort Madison, Iowa, aggregating 70,000 shares in all (Stip. of Facts, para. 3, T.C.R. Doc. No. 8). The transfer of these shares of stock by the settlor to the trustee resulted in a Federal gift tax. As to the payment of this tax the trust agreement of February 2, 1954, provided as follows:

> "SECTION I: The trustee agrees that, to the full extent of the value of the corpus of the trust estate and the income therefrom, it will assume and pay all federal and state gift taxes (including all penalties and interest thereon, if any) which shall or may be assessed or become due from any one by reason of the transfer, assignment and delivery to it of the property listed in Schedule A or by reason of the creation of the trust estate hereunder; and, notwithstanding any other provision herein, the trustee agrees to assume, and to indemnify and hold all persons whomsoever harmless against and from, any obligation or liability whatsoever which they, or any of them, shall or may have for the payment of such taxes or for the reimbursement of, or contribution to, the trustee or any person whomsoever on account of the payment of such taxes. The trustee is authorized and agrees to obtain a loan in an amount sufficient to pay all such taxes and to pledge, or otherwise to apply such part or all of the corpus and income of the trust estate, and to take such other action, as shall be required or deemed advisable by the trustee in order to secure the loan. The trustee agrees to apply the proceeds of such loan in payment of such taxes."

Craig R. Sheaffer consented to the foregoing gifts in trust made by his wife and thereby these gifts were

considered as made one-half by each of them (Stip. of Facts, para. 4, 5, T.C.R. Doc. No. 8). The trustee prepared gift tax returns for Craig and Virginia for 1954, filed them with the District Director of Internal Revenue, Des Moines, Iowa, on March 14, 1955 (the day before the returns and payments were due), and at the same time paid the total gift taxes shown on the returns of $327,307.04 (Stip. of facts, para. 4-7, T.C.R. Doc. No. 8). Of this amount $188,607.04 was paid with trust income from the four trusts accumulated up to that time and $138,700 from proceeds of a loan obtained by the trustee in accordance with Section I of the trust agreement (Stip. of Facts, para. 7, T.C.R. Doc. No. 8).[2]

The trustee received dividends on the Pen Company stock in the amount of $140,000 in 1954 and $155,500 in 1955; a total of $295,500. Of such total income $188,607.04 was used to pay gift taxes; the balance of $66,892.96 was received and applied to repayment of the loan after the gift taxes had been paid.

The trustee filed fiduciary income tax returns for 1954 and 1955 for the four trusts, showing the income received by each in those years, including the income represented by the dividends on the Pen Company stock, and paid the income taxes shown to be due on such income (Stip. of Facts, para. 7, 14, T.C.R. Doc. No. 8 and Ex. 13-M through 20-T).

The respondent in his notice of deficiency (T.C.R. Doc. No. 2) added to taxable income of petitioners

[2] The respondent adjusted the value of the Sheaffer shares upward, and in 1958 the trustee paid additional gift taxes of $27,657.24 plus interest of $4,824.48, making the total gift taxes paid $354,964.28 after diminishing the value of the taxable gifts by the amount of the gift tax (Stip. of Facts, para. 9, T.C.R. Doc. No. 8). The amount of the gift tax is not now in dispute.

$140,000 for 1954 and $115,500 for 1955 (including the $66,892.96 received after payment of the gift tax) with the following explanation for each year:

> "It is determined that Virginia D. Sheaffer, as a donor, and Craig R. Sheaffer, as a beneficiary,[3] realized income of $140,000 in this year [1954, and $115,500 in 1955] from Virginia D. Sheaffer trusts which were created under a trust agreement dated February 2, 1954, as such income was applied by the trustee as a partial payment of a legal obligation of these taxpayers."

The deficiencies so asserted were determined by the Tax Court in the amounts of $120,008.64 for 1954 and $78,352.25 for 1955, a total of $198,360.89 (T.C.R. Doc. No. 14).

The Court of Appeals for the Eighth Circuit affirmed (Appendix B and C, *infra*, pp. 14a-24a).

REASONS FOR GRANTING THE WRIT

The donors, the donees, and the gift assets were all liable for the gift tax, which is an excise. The donors reserved nothing by way of principal or income from the gift and were in no way enriched by the creation or satisfaction of the gift tax liability. The Government has not contended that the donors would have realized income if they had made these gifts outright rather than in trust. Nevertheless the Court below held that petitioners, as donors, realized taxable income from the trustee's payment of the gift tax. The Court below thus decided an important question of income tax law which has not been, but should be, decided by this Court. The decision below is in conflict with a decision of the Sixth Circuit involving

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[3] The Tax Court correctly treated both Virginia and Craig as donors.

a gift tax payment under similar circumstances. It is also in conflict with important principles of law established by this Court for the determination of taxable income.

I. THE DECISION BELOW CONFLICTS WITH THE SIXTH CIRCUIT'S HOLDING IN COMMISSIONER v. ESTATE OF MORGAN

A. In Morgan, Trust Income Used to Repay the Trust's Loan (Rather Than to Pay Gift Tax Directly) Was Not Taxable to the Grantor, Since She Was Not Liable for the Loan.

In its *per curiam* decision, ___ F. 2d ___, 11 A.F.T.R. 2d 1228 (1963), the Sixth Circuit adopted the findings of fact and opinion of the Tax Court, 37 T.C. 981 (1962). That Tax Court opinion and the Sixth Circuit decision affirming it are set forth as Appendix E, *infra*, pp. 31a-38a. In both the *Morgan* and *Sheaffer* cases the settlors established trusts for their children. In each case by the terms of the trust instrument the trustee was responsible for the payment of the gift tax. In each case, pursuant to authorization in the trust instrument, the trustee borrowed money, secured by the trust's assets, and applied the proceeds of the loan to payment of the gift tax. The settlor was not a party to the loan nor liable for its repayment. In *Morgan* the entire amount of the gift tax was borrowed, while in *Sheaffer* a part of it was borrowed—the balance of the gift tax being paid with accumulated trust income. In each case the trustee applied subsequent trust income to the repayment of the loan.

In *Sheaffer* the income so applied in payment of the loan was held taxable to the settlor. In *Morgan* it was not. In *Morgan* the Tax Court pointed out that payment of the tax with borrowed money is essentially the same as payment with principal. The subsequent

use of income to repay the loan—in effect to restore the principal—favors the corpus beneficiaries at the expense of the income beneficiaries. But it does not benefit the settlor, provided she retains no beneficial interest in the trust.

The very same is true with respect to the $66,892.96 of 1955 *Sheaffer* income used to repay the loan for which the trust but not the settlor was liable. The only remaining difference between the two cases is that the $66,892.96 of *Sheaffer* income was received in the same year in which the gift tax was paid, while the *Morgan* income was received in a subsequent year, so that the year of the gift tax payment was not before the Court in *Morgan*.

The Court below did not attempt to distinguish *Morgan*. It simply stated that *Morgan* was not "controlling or dispositive" and took note of the fact that Morgan at that time was on appeal before the Sixth Circuit. Appendix B, p. 22a.

Surely there is no tenable distinction here in terms of the statute under which the Sheaffers were held liable. Section 677 of the Internal Revenue Code of 1954, 68A Stat. 1, 230, taxes a grantor on trust income that "is, or . . . may be . . . distributed to the grantor." Thus the test is how the specific income involved is or may be used. Once the gift tax has been paid, from that instant on not one cent of subsequent income is or can possibly be used to pay it. This is equally true of subsequent income received in the same year and that received in the next year. Thus as to $66,892.96 of the *Sheaffer* income, the decision below is squarely and irreconcilably in conflict with *Morgan*. This conflict has already aroused public concern. See 12 U.S. Tax Week 712, 713 (April 19, 1963); 41 Taxes 259 (May, 1963).

B. The Decision Below Cannot in Any Respect Fairly Be Reconciled With Morgan.

The settlor in neither *Morgan* nor *Sheaffer* had any obligation to pay the money borrowed by the trustee. So it can not be said that the income applied in repayment of either loan satisfied a legal obligation of either settlor. And *Morgan* so held; but *Sheaffer* did not.

The only variation of any significance between the two cases was the use of the trust income in *Sheaffer* for the direct payment of a part of the gift tax. We submit it makes no difference for income tax purposes whether the trustee pays the settlor's obligation with income or borrows money and uses the income to repay the loan. This is too fine a distinction on which to predicate large differences in tax liabilities. The three dissenting Tax Court judges in the *Morgan* case argued that there was no valid distinction here, but they, like the Court below, failed to appreciate the reasons why judgment in both cases should have gone for the taxpayers. We now turn to those considerations.

II. THE DECISION BELOW IS IN CONFLICT WITH IMPORTANT AND WELL-ESTABLISHED PRINCIPLES GOVERNING CONSTRUCTIVE RECEIPT OF INCOME.

A. The Donors Did Not Constructively Receive Income from the Gift Tax Payment, Any More Than if They Had Made the Same Gift Not in Trust.

Section 677 of the Internal Revenue Code of 1954, 68A Stat. 1, 230, taxes income "distributed to the grantor" or "held or accumulated for future distribution to the grantor." But in the present case no payment was made "to" the grantor. The question is one of constructive receipt.

The guiding principles of constructive receipt are found in the cases decided under section 61(a) of

the 1954 Code, 68A Stat. 1, 17, and its predecessors. That section taxes "income . . . derived" by the taxpayer. If such cases were not relevant, then indeed we would be in uncharted seas. When the question is whether a payment made to somebody else is attributable to the taxpayer, there is no difference in the standards we should apply in deciding whether income has been "derived" by the taxpayer (sec. 61) from those we use in deciding whether income has been "distributed to" him (sec. 677). Under both sections the question is whether the transaction is in substance a payment to the taxpayer. The ruling cases in this field would have been decided the same way whether or not trusts were involved.

The Court below relied on *Staley* v. *Commissioner*, 136 F. 2d 368 (5th Cir. 1943), which presented no question of constructive receipt. Trust income in that case was "distributed to the grantor" (sec. 677). It was irrelevant that the grantor wanted the money to use in payment of the gift tax, when he could do with it as he saw fit. The grantor in this case received nothing.

Neither the Commissioner nor the Court below has contended that the taxpayers here would have received taxable income from these transactions if their gift had not been made in trust. If a donor makes a gift of the legal title to property, and the donee pays the gift tax, no income is realized by the donor, whether the funds used are from principal or income. The Court below based its decision entirely upon "the basic fact that the transfer in this case was made in *trust*" (Court's emphasis), and thereupon disregarded all the non-trust cases cited by the taxpayers showing the standards that have been developed for determin-

ing the constructive receipt of income. Appendix B, p. 22a. In this way the Court below disregarded important and well established legal principles because of form—the trust form of the transaction.

B. The Only Purpose of Section 677 Is to Prevent Avoidance, Through the Use of Trusts, of Taxes Otherwise Applicable.

It was no part of the Congressional purpose to tap a new source of income when it enacted the predecessor of section 677. Rather it was designed to meet and overcome the growing use of trusts as a device for escaping taxes which would be applicable in the absence of the trust device.

Over the years Congress has been engaged in a defensive battle to keep the tax base from being whittled away by newer and more ingenious trusts. This is apparent from the committee reports as section 677 has developed from its beginning in the Revenue Act of 1924, 43 Stat. 253, 257. H. Rep. No. 179, 68th Cong., 1st Sess., p. 21 (1924); S. Rep. No. 665, 72nd Cong., 1st Sess., pp. 34-5 (1932). This Court made the same point in *Helvering* v. *Stuart*, 317 U.S. 154, 167 (1942), when it said:

> "Section 167 [the predecessor of 677] took its present form in the Revenue Act of 1932. It was enacted especially to prevent avoidance of surtax by the trust device, when the income really remained in substance at the disposal of the settlor . . . It is to be interpreted in the light of its purpose for the protection of the federal revenue . . . Of course, where the settlor or donor is not actually or in substance a present or possible beneficiary of the trust, he escapes the surtax by a gift in trust."

Congress did not undertake to make payments taxable in a trust situation which would be non-taxable in a

non-trust situation. The taxpayer should not be rewarded or punished for casting his transaction in the form of a trust.

In making an unwarranted distinction between trust and non-trust cases, the court below mistakenly relied on *Douglas* v. *Willcuts*, 296 U.S. 1 (1935), as a case decided under the forerunner of Section 677. In fact *Douglas* was decided under the predecessor of Section 61. The Court below missed the major lesson in *Douglas* and in *Helvering* v. *Fuller*, 310 U.S. 69 (1940), that transfers in trust produce the same tax consequences as the same transactions in the form of outright gifts. "The creation of a trust . . . leaves the nature of the transaction unaltered." *Douglas* v. *Willcuts*, 296 U.S. 1, 9 (1935).

C. Payment of a Liability by One Obligor Is Not Income to a Co-obligor.

The concept of constructive receipt of income through the discharge of a legal obligation has been developed by decisions of this Court. The two landmark cases forming the basis of this doctrine are *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716 (1929) (payment of income tax by another); and *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931) (forgiveness by a creditor of part of an indebtedness). *Douglas* v. *Willcuts*, 296 U.S. 1 (1935), showed how the same principle (under the predecessor of section 61) can be applied to a trust whose income is devoted to satisfaction of the settlor's legal obligation. This brings us to the area of Section 677, which is a special statute dealing with trusts, but where the principles are the same insofar as constructive receipt is concerned.

This court has not had occasion to mark out the limits of this doctrine. The instant case discloses the need for such a determination. Some of the Courts of Appeals have done so in two respects applicable to this case.

One such limitation is the proposition that where two or more people are liable for a debt, anyone can pay it without giving rise to income on the part of the others. The second limitation is treated in point D, *infra*, p. 13. The outstanding case on this point is *Ruben* v. *Commissioner*, 97 F. 2d 926 (8th Cir. 1938). In that case a corporate judgment debtor compromised and paid a tort judgment which was also entered against individuals including the taxpayer. The Commissioner determined that Ruben had realized taxable income by reason of the payment of his legal obligation. The Court of Appeals held that it did not matter who was primarily liable for the judgment, and that none of the judgment debtors received any income from the settlement and payment made by the corporate debtor.

To the same general effect are *Tucker* v. *Commissioner*, 226 F. 2d 177 (8th Cir. 1955); and *Commissioner* v. *Hopkinson*, 126 F. 2d 406 (2nd Cir. 1942).

D. Income Does Not Arise from Discharge of An Obligation Gratuitously Incurred.

At one time it might have been argued that the doctrine of *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931), should be extended to the point where any taxpayer would realize income from a diminution in liabilities unaccompanied by a diminution in assets. The

courts have recognized, however, that there are situations in which that would be unfair and would seriously strain the concept of income. *Bowers* v. *Kerbaugh-Empire Co.*, 271 U.S. 170 (1926), is authority for the proposition that the entire transaction may be viewed to determine whether taxable income was derived from the cancellation of indebtedness for less than full consideration.

The Courts of Appeals have correctly applied this principle in situations where the cancelled indebtedness was incurred in the first instance without consideration or benefit to the taxpayer. It would be unreasonable to say a taxpayer realizes income simply by escaping liability. Good examples of this proposition are: *Ruben* v. *Commissioner*, 97 F. 2d 926 (8th Cir. 1938) (payment of a tort judgment by a co-defendant); *Bradford* v. *Commissioner*, 233 F. 2d 935 (6th Cir. 1956) (redemption at half price of a note given for another person's indebtedness); *Commissioner* v. *Rail Joint Co.*, 61 F. 2d 751 (2nd Cir. 1932) (repurchase at less than face value of bonds issued to stockholders as a dividend); see also Surrey, "The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness," 49 Yale L.J. 1153 (1940).

Moving into the trust field, the same consideration limits the applicability of Section 677 of the 1954 Code. The Fifth Circuit in *Edwards* v. *Greenwald*, 217 F. 2d 632, 634 (5th Cir. 1954) relied on the same kind of facts that should have led to a decision for the taxpayers in the present case:

> "[I]n the instant case the indebtedness of the trustees individually [the grantor-taxpayers] was

> incurred contemporaneously with the establishment of the trusts and was incurred solely for accommodation of the trust and under the trust instruments no benefit or right to receive income was reserved to the trustees as individuals. This being the situation it follows that the trustees' payment of this indebtedness . . . simply operated to increase the corpus of the trusts from which neither of the trustees individually could receive either income or corpus."

Helvering v. *Blumenthal*, 296 U.S. 552 (1935), reversing 76 F. 2d 507 (2nd Cir. 1935),[4] is not to the contrary. That case is simply *Kirby Lumber* in trust form. The taxpayer borrowed money. Such a receipt would have been income in the first instance but for the obligation to repay it. In *Kirby Lumber* the obligation to repay was partially cancelled, whereas in *Blumenthal* trust income was used to discharge the obligation. In the present case the taxpayers had no pre-existing indebtedness. In incurring the gift tax indebtedness they obtained no receipt or benefit.

E. The Primary or Secondary Nature of a Discharged Obligation Is Not a Valid Criterion for Determining the Realization of Income.

A gift tax is an excise payable by the donor, the donee, or out of the gift assets. Internal Revenue Code of 1939, sections 1000(a), 1008(a), 1009.[5] Payment by one extinguishes the liability of others but

[4] In that case the settlor was held taxable not as a grantor under the predecessor of Sec. 677 but as a beneficiary under Sec. 162(b) of the Revenue Act of 1928, 45 Stat. 791, 838.

[5] In this case the applicable Internal Revenue Code pertaining to the income tax is the 1954 Code, and the applicable Code pertaining to the gift tax is the 1939 Code.

does not thereby give rise to taxable income for the others. Donor, donee, and gift assets all become liable at the time of the gift, although they are subject to different rules as to whether and when payment is required. Section 1009, Internal Revenue Code of 1939, 53 Stat. 1, 149.

The Court below thought it important that the donor's liability for the gift tax is "primary" in terms of sections 1008 and 1009 of the 1939 Code. The Court below also thought it important that the tax was paid the day before it was due rather than the day after. Appendix B, p. 19a. The Court has confused liability for the tax, which was common to all, with the requirement for payment on different dates by donor and donee.

The correct principle to apply is that one obligor does not receive income when a co-obligor pays the obligations. It makes no difference whether the liability of one of the obligors may be in a sense "primary", as held in *Ruben* v. *Commissioner*, 97 F. 2d 926 (8th Cir. 1938). If it were otherwise, a tortfeasor servant, primarily liable, would receive income on the payment of the victim by his master.

Congress provided a comprehensive plan for seeing that the gift tax was paid. Apart from this objective it was not concerned with the problem of who made the payment. A similar legislative indifference appears in the collections excise taxes, such as those on transportation, dues, and admission fees. In fact, when the first gift tax act (1924) was being debated in the House of Representatives, the Chairman of the Ways and Means Committee (Representative William

R. Green) exhibited some confusion and little interest in determining where the impact of the tax would fall. In short, he considered it "immaterial" whether the donor or donee paid the tax. 65 Cong. Rec. 3120 (February 25, 1924).

The Government has no justification for requiring payment of the gift tax from donor rather than from donee. If a donor plans to make a gift and pay the tax himself, he can take the amount he has available for the purpose and figure out what portion of it should constitute the gift, so that the remainder, the correct amount of the tax, can be withheld. On the other hand, he can give the whole amount to the donee and require the donee to pay the tax. The amount of the Government's take from the gift tax is precisely the same, whether it comes from the donor, the donee, or the gift assets. Here the parties to the gift have by contract, in the light of applicable state law expressly made the donee primarily liable for the gift tax and responsible to the donor for seeing that it was paid.

CONCLUSION

In view of the importance of this case to the Federal tax laws, of the error in the decision of the United States Court of Appeals for the Eighth Circuit in disregarding general legal principles merely because of the involvement of a trust, and of the conflict between the decision below and the Sixth Circuit's decision in *Commissioner* v. *Estate of Morgan*, (Appendix E, p.

38a) the petition for a writ of certiorari should be granted.

Respectfully submitted.

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APPENDIX A

37 T.C. 99

TAX COURT OF THE UNITED STATES

CRAIG R. SHEAFFER and VIRGINIA D. SHEAFFER, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Docket No. 84269. Filed October 31, 1961.

In 1954 petitioner Virginia D. Sheaffer entered into a trust agreement with a bank as trustee wherein petitioner created a separate trust for each of her four children and transferred to the trustee 70,000 shares of the common stock of W. A. Sheaffer Pen Company. The trustee agreed to assume and pay all gift taxes which shall or may be assessed or become due from anyone by reason of the transfer. In 1954 and 1955 the Pen Company paid the trustee as dividends on the 70,000 shares the amounts of $140,000 and $115,500, respectively. On March 14, 1955, petitioners each filed a United States gift tax return wherein each spouse consented to have the gifts each one made during 1954 considered as having been made one-half by each spouse. The total gift taxes shown on both returns amounted to $327,307.04, which amount was paid by the trustee on March 14, 1955, partly out of dividend income and partly with borrowed funds. Petitioners filed joint income tax returns for the calendar years 1954 and 1955. The respondent, in determining the income tax deficiencies for both years, determined that the above dividends received by the trustee were taxable income to petitioners. *Held*, respondent did not err in so including the above dividends in petitioners' income.

Aaron Holman, Esq., for the petitioners.

Leo A. McLaughlin, Esq., and *John W. Holt, Esq.*, for the respondent.

OPINION

ARUNDELL, *Judge:* Respondent determined deficiencies in income tax for the calendar years 1954 and 1955 in the amounts of $125,910.80 and $84,683.81, respectively.

The only issue remaining is whether the respondent erred in determining that in the calendar years 1954 and 1955 petitioners realized income in the amounts of $140,000 and $115,500, respectively, "on the theory that such income, which was earned by the trusts created by petitioner Virginia D. Sheaffer under a Trust Agreement dated February 2, 1954, was applied by the trustee thereof as partial payment of an alleged legal obligation of the taxpayers." (Petition.)

Another issue relating to a dividend received credit under section 34 of the Internal Revenue Code of 1954 has been conceded by the respondent and effect will be given to this concession in any recomputation to be made under Rule 50.

We find the facts as stipulated and set forth only those deemed necessary in reaching our decision.

Petitioners are husband and wife residing at High Point, Fort Madison, Iowa. They filed joint Federal income tax returns for the taxable years 1954 and 1955 with the district director of internal revenue, Des Moines, Iowa.

On February 2, 1954, petitioner, Virginia D. Sheaffer (hereinafter sometimes called Virginia), entered into an agreement as settlor with Harris Trust and Savings Bank, of Chicago, Illinois, as trustee, wherein she created four separate trusts, one for the benefit of each of her four children. The agreement allocated the corpus of the trust estate to the aforesaid trusts in the proportion of 25/70, 25/70, 10/70 and 10/70, respectively.

Upon the execution of the trust agreement, Virginia assigned and delivered to the trustee certificates totaling

70,000 shares of the common stock of W. A. Sheaffer Pen Company, to be divided among the four trusts in the proportions stated above. On December 31, 1955, the trustee held those identical certificates, i.e., none having been disposed of except that the shares were deposited by the trustee as collateral security for the loan referred to later in this opinion.

Section I of the trust agreement reads as follows:

> The trustee agrees that, to the full extent of the value of the corpus of the trust estate and the income therefrom, it will assume and pay all federal and state gift taxes (including all penalties and interest thereon, if any) which shall or may be assessed or become due from any one by reason of the transfer, assignment and delivery to it of the property listed in Schedule A or by reason of the creation of the trust estate hereunder; and, notwithstanding any other provision herein, the trustee agrees to assume, and to indemnify and hold all persons whomsoever harmless against and from, any obligation or liability whatsoever which they, or any of them, shall or may have for the payment of such taxes or for the reimbursement of, or contribution to, the trustee or any person whomsoever on account of the payment of such taxes. The trustee is authorized and agrees to obtain a loan in an amount sufficient to pay all such taxes and to pledge or otherwise to apply such part or all of the corpus and income of the trust estate, and to take such other action, as shall be required or deemed advisable by the trustee in order to secure the loan. The trustee agrees to apply the proceeds of such loan in payment of such taxes.

On or about March 11, 1955, the Harris Trust and Savings Bank, the trustee of said trusts, prepared a gift tax return for Virginia with respect to the aforesaid gifts of

stock to the trusts. The said return was signed by Virginia as donor; and petitioner Craig R. Sheaffer (hereinafter sometimes called Craig), as her husband, signed the consent appearing thereon to have the gifts made by them during the calendar year considered as having been made one-half by each of them.

Pursuant to the requirements of the trust agreement, the trustee filed the gift tax return on March 14, 1955, with the district director of internal revenue, Des Moines, Iowa. The amount of gift tax shown on the return was $167,559.64. At the time that it filed the return, the trustee paid the gift tax with its own check in the aforesaid amount drawn on the trust account.

On the same date that the trustee prepared the aforesaid gift tax return for Virginia, it prepared a gift tax return for Craig with respect to the aforesaid gifts of stock to the trusts. The return was signed by Craig as donor, and Virginia, as his wife, signed the consent appearing thereon to have the gifts by them during the calendar year considered as having been made one-half by each of them. Pursuant to the requirements of the trust agreement the trustee filed the gift tax return for Craig on March 14, 1955, with the district director of internal revenue, Des Moines, Iowa. The amount of gift tax shown on the return was $159,747.40. At the time that it filed the return, the trustee paid the gift tax with its own check in the aforesaid amount drawn on the trust acount.

On or about March 7, 1955, the trustee executed and filed with the district director of internal revenue, Des Moines, Iowa, trustee's information returns with respect to the aforesaid gifts of stock to each separate trust.

The gift taxes paid by the trustee on filing the aforesaid gift tax returns in the total amount of $327,307.04, were charged to the respective trusts in the proportions of 25/70, 25/70, 10/70 and 10/70 pursuant to provisions of the trust agreement.

At the time the trustee paid the aforesaid gift taxes totaling $327,307.04, it had received income aggregating $188,607.04 for the accounts of the four trusts. Pursuant to the provisions of the trust agreement, the trustee borrowed $138,700 for the four trusts on the security of the trust assets, charging the trusts with their respective amounts thereof in the proportions stated above. The payment of the aforesaid gift taxes was thereafter made with the total of the borrowed funds and of the accumulated income then on hand.

In the gift tax return of Virginia (Schedule A), the market value of the 70,000 shares of W. A. Sheaffer Pen Company stock was reported at $24.50 per share on the date of the gift, or a total of $1,715,000. From this amount Virginia deducted the total gift taxes of $327,307.04 paid by the trustee, leaving $1,387,692.96 as the "Value at date of gift," to which was added $9,500 of other gifts made by Virginia during 1954, thus bringing the "Total gifts of donor" for 1954 up to $1,397,192.96.

In the gift tax return of Craig (Schedule A), Craig reported "Total gifts of donor" for 1954 of $6,000 to his wife Virginia.

Schedule A of both returns then continued thus:

	Virginia	Craig
(a) Total gifts of donor	1,397,192.96	$ 6,000.00
(b) Less portion [½ of (a)]	698,596.48	0
(c) Balance	698,596.48	6,000.00
(d) Gifts of spouse [item (b)]	0	698,596.48
(e) Total gifts for year	698,596.48	704,596.48
(f) Less total exclusions	4,750.00	7,750.00
(g) Total included amt. of gifts for year	693,846.48	696,846.48
(h) Deduction	0	4,570.67
(i) Total deductions	0	4,570.67
(j) Amount of net gift for year	$693,846.48	$692,275.81

On audit of the returns the respondent determined that the value of the shares on the date of the gift was $26.3672 per share or a total of $1,845,704. The resulting deficiency in tax of $27,657.24 ($14,132.35 for Virginia and $13,524.89 for Craig) plus interest of $4,824.48, making a total of $32,481.72, was paid by the trustee on February 10, 1958, and charged to the four trusts in the respective proportions stated above. In determining the deficiencies in gift tax against Virginia and Craig, the respondent followed the same pattern used by petitioners in their gift tax returns and, as a part of that pattern, deducted the total gift taxes of $354,964.28 from the total redetermined value of the shares of $1,845,704 to arrive at the redetermined "Value at date of gift" of $1,490,739.72.

In 1954 the trustee received dividends on the 70,000 shares of W. A. Sheaffer Pen Company stock in the amount of $140,000. These funds were used to purchase in 1954

U. S. Treasury notes in the amount of $136,643.14. In 1955 the trustee received dividends on the aforementioned stock in the amount of $115,500. In 1954 and 1955 the trustee received interest in the Treasury notes in the amounts of $990 and $997.46, respectively. On or about March 11, 1955, the trustee sold for $136,000 the Treasury notes purchased in 1954.

The total receipts and disbursements of the four trusts in the calendar years 1954 and 1955 were as follows:

Receipts	
Dividends on stock of W. A. Sheaffer Pen Co.	$255,500.00
Interest on U.S.A. Treasury notes	1,987.46
Proceeds of sale of U.S.A. Treasury notes	136,000.00
Proceeds of loan	202,680.00
	$596,167.46

Disbursements	
U.S.A. Treasury notes purchased	$136,643.14
Interest paid on U.S.A. Treasury notes purchased	651.76
Trustee's fees and expenses	6,508.68
1954 Federal income tax	63,981.66
Federal gift tax	327,307.04
Principal and interest payment on notes	61,075.18
	$596,167.46

In its income tax returns for 1954 and 1955 the trustee reported as taxable income all dividends received by it in the said years on the aforesaid 70,000 shares of stock of W. A. Sheaffer Pen Company as well as the interest income that it received in those years. The total Federal income tax paid by the trustee on the income so reported was $63,981.66.

The respondent in determining the instant income tax deficiencies against petitioners increased petitioners' tax-

able income as disclosed by their joint returns for 1954 and 1955 by "Dividend Income for benefit of Grantor" in the respective amounts of $140,000 and $115,500 and, in a statement attached to the deficiency notice, explained these adjustments thus:

> (a) It is determined that Virginia D. Sheaffer, as a donor, and Craig R. Sheaffer, as a beneficiary, realized income of $140,000.00 in this year [1954, and $115,500 in 1955] from Virginia D. Sheaffer Trusts which were created under a Trust Agreement dated February 2, 1954, as such income was applied by the trustee as a partial payment of a legal obligation of these taxpayers.

At the outset, it may be noted that the applicable Internal Revenue Code pertaining to the instant income tax deficiencies is the 1954 Code and the applicable Code pertaining to the gift tax is the Internal Revenue Code of 1939. See section 7851, I.R.C. 1954.[1]

Also, at the outset it may be noted that in the statement attached to the deficiency notice the respondent refers to Virginia as a donor and to Craig as a beneficiary. For the

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[1] SEC. 7851. APPLICABILITY OF REVENUE LAWS.

(a) General Rules.—Except as otherwise provided in any section of this title—

(1) Subtitle A [Income Taxes]—

(A) Chapters 1 • • • of this title shall apply only with respect to taxable years beginning after December 31, 1953, and ending after the date of enactment of this title • • •.

• • • • • •

(2) Subtitle B [Estate and Gift Taxes].—

• • • • • •

(B) Chapter 12 [Gift Tax] of this title shall apply with respect to the calendar year 1955 and all calendar years thereafter, and with respect to such years chapter 4 of the Internal Revenue Code of 1939 is hereby repealed.

purposes of this case, we think both Virginia and Craig must be considered as donors of the 70,000 shares of the Pen Company stock. Section 1000 (f), I.R.C. 1939, provides in part:

> (f) Gift of Husband or Wife to Third Party.—
>
> (1) Considered as made one-half by each.—
>
> (A) In General.—A gift made after the date of the enactment of the Revenue Act of 1948 by one spouse to any person *other than his spouse*, shall, for the purpose of this chapter, *be considered as made one-half by him and one-half by his spouse* * * *.
>
> (B) Consent of Both Spouses.—Subparagraph (A) shall be applicable only if both spouses have signified * * * their consent to the application of subparagraph (A) in the case of all such gifts made during the calendar year by either while married to the other. [Italics supplied.]

On page 1 of their respective gift tax returns for 1954, both Virginia and Craig signed the "Consent of Spouse" consenting to have the gifts made by each of them to third parties considered as having been made one-half by each. This was in accordance with section 1000 (f), *supra*. Accordingly, we will consider both Virginia and Craig as the donors of the 70,000 shares transferred to the trustee on February 2, 1954.

It is our opinion that the respondent properly determined that the dividends received by the trustee of $140,000 in 1954 and $115,500 in 1955 are taxable to petitioners in those years under section 677 of the Internal Revenue Code of

1954.[2] The trustee used those dividends for the benefit of petitioners in paying the greater part of their gift tax liability for the calendar year 1954 of $327,307.04. It is clear beyond doubt that petitioners are by statute, regulations, and Court decisions made primarily liable for the gift tax. Section 1008 (a), I.R.C. 1939, provides that "The tax imposed by this chapter shall be paid by the donor on or before the 15th day of March following the close of the calendar year." Section 86.3 of Regulations 108 provides that "the tax is a primary and personal liability of the donor." Section 1009 of the 1939 Code provides: "If the tax is not paid when due, the donee of any gift shall be personally liable for such tax to the extent of the value of such gift."[3] In *Fletcher Trust Co.* v. *Commissioner*, 141 F. 2d 36 (C.A. 7, 1944), certiorari denied 323 U.S. 711, affirming 1 T.C. 798, the court stated, in discussing sections 509 and 510 of the Revenue Act of 1932, the predecessor of sections 1008 and 1009 of the 1939 Code, that:

> The provisions of the Act to which we have referred make plain, so we think, that the liability of the donor is primary and that of the donee secondary. In other words, it is only when the former fails to pay the tax

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[2] SEC. 677. INCOME FOR BENEFIT OF GRANTOR.

(a) General Rule.—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a non-adverse party, or both, may be—

(1) distributed to the grantor;

(2) held or accumulated for future distribution to the grantor • • •

[3] The tax here involved was due March 15, 1955 (sec. 1008 (a), I.R.C. 1939). The trustee paid the tax of $327,307.04 shown on the returns on March 14, 1955, and the deficiency of $27,657.24 on February 10, 1958. Since the original tax of $327,307.04 is greater than the income here in question of $255,500, we need not be concerned any further with the deficiency.

that it becomes the liability of the latter. This is so even though the liability of the donee may attach the next day after that on which the donor becomes liable.

In the instant case the trustee paid the gift tax shown on the returns before it became due. Actually, therefore, the donee never became "personally liable for such tax" for at the time the tax was paid, the only existing statutory liabilities for the tax were those of Virginia and Craig. Even if the tax had not been paid when due, the personal liability of the donee would only run concurrently with the continuing liability of the donor. The original primary liability is that of the donor and it continues even after the donee becomes additionally liable. In this respect it would not seem important whether the donor's original and continuing liability is satisfied before or after the donee also becomes liable for the tax. Thus, in paying the tax before or by the due date, the trustee is clearly satisfying the exclusive and statutory liability of the donor. That clear and obvious fact is dispositive of this case.

In the instant case the trust agreement specifically provided that the trustee was to pay the donor's gift tax liability. Future income of the trust estate was reserved for that purpose. The trustee did pay the gift tax of $327,307.04 shown on petitioners' returns before it became due. We think the result of this reservation and payment is to make the donors taxable under section 677, *supra*, on the funds so used in their behalf to the extent of the income of $255,500 received by the trustee. *Douglas* v. *Willcuts*, 296 U.S. 1; *Lucy A. Blumenthal*, 30 B.T.A. 591, revd. 76 F. 2d 507 (C.A. 2, 1935), but affd. 296 U.S. 552 (1935); *Clifton B. Russell*, 5 T.C. 974, petition for review dismissed, 154 F. 2d 829; *Herbert A. Loeb*, 5 T.C. 1072, affd. 159 F. 2d 549 (C.A. 7, 1947). See also *Estate of A. E. Staley, Sr.*, 47 B.T.A. 260, affd. 136 F. 2d 368 (C.A. 5, 1943), certiorari denied, 320 U.S. 786.

The Staley case was a case where the taxpayer who was the owner of 80 percent of a corporation's common stock,

transferred into trusts created for each of his five children certain common and preferred shares. On realizing that the gift tax would exceed his available cash by approximately $150,000, the taxpayer decided upon a plan to have each of the five trusts pay over to him out of trust income all such income (after paying expenses and fees) until each trust had paid him $30,000. In holding that the grantor was taxable on the $150,000 so reserved, we said (p. 265):

> The simple fact is that decedent was providing a means of securing $150,000 from the first income of the trusts, and this income he received. The fact that payment of the $150,000 was to be made out of income is indicative of decedent's retention of a right to income in that amount. See *Bettendorf* v. *Commissioner*, 49 Fed. (2d) 173. Whether we say decedent made himself a preferred beneficiary of the trusts to the extent provided, *Annie Louise Van Aken*, 35 B.T.A. 151, or that he reserved $150,000 of the income of the trusts when he made the gifts, *Michael Fay et al., Executors*, 34 B.T.A. 662, is of no particular importance in determining the fundamental question of whether or not the sum received was taxable income. * * *

We see no material difference in principle between making a gift of stock in trust with a reservation (after paying expenses and fees) of the first $150,000 of income, which the settlor intended to use to pay his gift taxes directly, as in *Staley*, and, as in the instant case, the making of a gift of stock in trust with a provision in the trust instrument that the trustee is to pay the gift tax. In both cases, income is reserved for the benefit of the donor and, under section 677, is taxable to the donor.

Petitioners contend that when the trustees paid the gift tax shown on the returns to be due, it was discharging the liability of the donees rather than that of the donor. We have previously shown herein that, under the statute, the

donor is primarily liable for the gift tax and that the donee's liability arises only if the tax is not paid when due. Here, the tax shown on the gift tax returns was paid the day before it became due so, in reality, the donees in the instant case never became liable for the tax that was paid on March 14, 1955. However, even if the tax had not been paid when due and the donees had become personally liable therefor under section 1009 of the 1939 Code, the liability of the donor would nevertheless continue until the tax was paid. The case of *Edwards* v. *Greenwald*, 217 F. 2d 632 (C.A. 5, 1954), is of no help to petitioners. In that case the trustees of certain trusts paid off certain indebtedness for which they were *primarily* liable, whereas in the instant case Congress has made the donor primarily liable for the tax, which liability continues until the tax is paid.

We sustain the respondent's determination on the authority of the cases previously mentioned. Because of the concession made by the respondent relating to a dividend received credit,

Decision will be entered under Rule 50.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT.

No. 17,075

ESTATE OF CRAIG R. SHEAFFER, DECEASED, WALTER A. SHEAFFER, II, and JOHN D. SHEAFFER, EXECUTORS, and VIRGINIA D. SHEAFFER, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

On Petition for Review of a Decision of the Tax Court of the United States

[February 13, 1963]

Before SANBORN, VAN OOSTERHOUT and MATTHES, Circuit Judges.

MATTHES, Circuit Judge.

This case is here on petition to review the decision of the Tax Court which determined deficiencies in federal income taxes against petitioners for the calendar years 1954 and 1955 in the amounts of $120,008.64 and $78,352.25, respectively. The decision of the Tax Court is reported at 37 T.C. 99 (1961).

The underlying question for determination is whether for federal income tax purposes, the 1954 and 1955 income derived from the corpus of trust property and applied by the trustee toward payment of the federal gift tax on the corpus was income to the donors (settlors) of the property.[1] The pertinent facts were stipulated and so found by the Tax Court.

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[1] In this case, the applicable Internal Revenue Code pertaining to the income tax deficiencies is the 1954 Code and the applicable code pertaining to the gift tax is the 1939 Code.

Craig R. Sheaffer and Virginia D. Sheaffer, as husband and wife,[2] filed joint federal income tax returns for 1954 and 1955. On or about February 2, 1954, Virginia D. Sheaffer, as settlor, executed a trust instrument whereby she created four separate trusts for each of her four children and named Harris Trust and Savings Bank of Chicago, Illinois, as trustee. Upon execution of the trust agreement, Virginia assigned and delivered to the trustee certificates for 70,000 shares of the common stock of W. A. Sheaffer Pen Company, and on December 31, 1955, the trustee held these identical certificates.

Section 1 of the trust agreement is relevant to the litigated question and provides:

> "The trustee agrees that, to the full extent of the value of the corpus of the trust estate and the income therefrom, it will assume and pay all federal and state gift taxes (including all penalties and interest thereon, if any) which shall or may be assessed or become due from any one by reason of the transfer, assignment and delivery to it of the property listed in Schedule A or by reason of the creation of the trust estate hereunder; and, notwithstanding any other provision herein, the trustee agrees to assume, and to indemnify and hold all persons whomsoever harmless against and from, any obligation or liability whatsoever which they, or any of them, shall or may have for the payment of such taxes or for the reimbursement of, or contribution to, the trustee or any person whomsoever on acount of the payment of such taxes. The trustee is authorized and agrees to obtain a loan in an amount sufficient to pay all such taxes and to pledge or otherwise to apply such part or all of the corpus and income of the trust estate, and to take such other action, as shall be required or deemed advisable by the trustee in order to secure the loan. The trustee agrees to apply the proceeds of such loan in payment of such taxes."

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[2] Craig R. Sheaffer died while the case was under consideration by the Tax Court and Walter A. Sheaffer, II, and John D. Sheaffer, as executors, were substituted as parties petitioners.

On or about March 14, 1955, the trustee, pursuant to the trust agreement, filed separate gift tax returns for Virginia and Craig covering the above mentioned stock. Virginia's return was signed by her as donor and by her husband Craig as consenting spouse pursuant to § 1000(f), Int. Rev. Code of 1939, which permits a gift made by one spouse to "be considered as made one-half by him and one-half by his spouse." The same procedure was followed with respect to the return filed on behalf of Craig; that is, he signed as donor and Virginia as his wife signed the consent. The Tax Court determined that under § 1000(f), Int. Rev. Code of 1939, "both Virginia and Craig must be considered as donors of the 70,000 shares of the Pen Company stock," and since this determination is not disputed by either party, we shall treat both Virginia and Craig Sheaffer as the donors or grantors. The gift tax due from Virginia as shown by her return was $167,559.64, and the gift tax due from Craig as shown by his return was $159,747.40. At the time the returns were filed, March 14, 1955, the trustee paid the gift tax, $327,307.04, with its own check and charged that amount to the respective trusts in the proportions indicated in the trust agreement.

As dividends on the 70,000 shares of stock, the trustee received $140,000 in 1954 and $115,500 in 1955. The total receipts and disbursements of the four trusts in the calendar years 1954 and 1955 are shown in detail in the Tax Court's decision and need not be restated here. For our purposes, it is sufficient to observe that the total gift tax of $327,307.04 (as computed by the trustee) was paid by the trustee with trust funds on hand of $188,607.04 and with the proceeds of a loan totaling $138,700 that the trustee had obtained on the security of the assets in the trust.

Upon audit of the gift tax returns the Commissioner of Internal Revenue determined that the value of the W. A. Sheaffer Pen Company stock was greater than that shown

on the returns and thus, that there was a deficiency in the gift tax payment. This deficiency, with interest, was paid by the trustee in 1958 and is not in controversy here.

The deficiency in the income tax of petitioners for the years 1954 and 1955 was predicated by the Commissioner in the first instance and later confirmed by the Tax Court on the theory that the dividends received by the trustee in the amount of $140,000 and $115,500 for 1954 and 1955, respectively, and which were applied by the trustee toward payment of the aforesaid gift tax, constituted income to the Sheaffers.

The Commissioner's position, summarily stated, is that under the trust agreement the trustee, a non-adverse party, had the discretionary right to apply the trust income to a reduction of the grantors' liabilities; that such discretion was exercised by application of the 1954 and 1955 trust income to payment of the gift tax which was the personal and primary liability of the grantors; and that these circumstances bring this case within the provisions of § 677 of the 1954 Internal Revenue Code and justified treatment of such income as taxable to grantors.

Petitioners assert that the grantors, donee and gift assets all became liable for gift taxes at the time that the gift was made; that it cannot realistically be contended that liability of the grantors for such tax is primary and that of the donee and other secondary and tertiary. From this premise petitioners argue for application of the rule that where more than one person is responsible for a debt, payment by one of them does not give rise to income on the part of the others.[3]

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[3] Petitioners cite non-trust cases, holding that payment of an obligation by one party having a financial interest in a transaction does not create income to another also financially interested, e.g. *Tucker* v. *Commissioner*, 8 Cir., 226 F. 2d 177 (1955); *Ruben* v. *Commissioner*, 8 Cir., 97 F. 2d 926 (1938).

At the outset we once again observe that the Tax Court's findings are presumptively correct—the burden rests upon petitioners to show that the findings upon which the Tax Court based its decision are clearly erroneous—and unless the findings are against the clear weight of the evidence or are induced by an erroneous view of the law, we are not, as a reviewing court, at liberty to disturb such findings on appeal. *Sachs* v. *Commissioner*, 8 Cir., 277 F. 2d 879, 881 (1960), cert. denied, 364 U.S. 833 (1960); *Estate of Craig M. Smith* v. *Commissioner*, 8 Cir., . . . F. 2d . . . , opinion filed Feb. 12, 1963. Here, as in *Estate of Craig M. Smith* v. *Commissioner*, supra, the facts were stipulated, but this circumstance "does not make this issue any less factual in nature. The Tax Court is entitled to draw whatever inferences and conclusions it deems reasonable from such facts." *Boehm* v. *Commissioner*, 326 U.S. 287, 293 (1945); *Estate of Craig M. Smith* v. *Commissioner*, supra, . . . at . . . .

Under § 1000 of the applicable 1939 Internal Revenue Code, a tax is imposed upon transfers of property, by gift, subject to certain exclusions and deductions set forth in other sections which are not pertinent here. Section 1006 requires a donor to file a gift tax return "on or before the 15th day of March following the close of the calendar year," and § 1008 imposes an obligation upon the donor to pay the gift tax on or before this same 15th day of March. Under § 1009, "The tax . . . shall be a lien upon all gifts made during the calendar year, for ten years from the time the gifts are made," and "*. . . the tax is not paid when due, the donee of any gift shall be personally liable for* such tax to the extent of the value of such gift." (Emphasis supplied). Also relevant is § 86.3 of Treasury Regulations 108 (1939 Code) which provides that:

> "The [gift] tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the

donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. *On the contrary, the tax is a primary and personal liability of the donor*, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identify of the donee may not then be known or ascertainable." (Emphasis supplied).

An examination of the controlling gift tax statutes and the cases interpreting them leads us to the inescapable conclusion that the liability for payment of the tax is in the first instance that of the donor, and the donee does not become liable unless the donor fails to make payment of the tax by the 15th day of March following the close of the calendar year. See *Mississippi Valley Trust Co.* v. *Commissioner*, 8 Cir., 147 F. 2d 186 (1945), and *Fletcher Trust Co.* v. *Commissioner*, 7 Cir., 141 F. 2d 36 (1944), cert. denied, 323 U.S. 711 (1944). Since the tax in this case was paid before the 15th day of March, we need not concern ourselves with the possible ramifications of a situation where payment of the tax was made at a time when both the donor and the donee were independently liable for the tax. Indeed, the primary obligation here was upon the donors; Virginia and Craig Sheaffer, and no additional liability, secondary or otherwise, ever arose since the gift tax shown on the returns was paid before it became due on March 15, 1955.

Remaining for our determination is the question whether the trust income applied by the trustee, pursuant to its express discretionary power, to the payment of the primary gift tax obligation of the grantors, was income constructively received by the grantors and therefore subject to the income tax in controversy. Here, the parties differ in their views as to the applicable statutes. Section 677 of the Internal Revenue Code of 1954 provides in pertinent part:

> "The grantor shall be treated as the owner of any portion of a trust * * * whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a non-adverse party, or both, may be—
>
> "(1) distributed to the grantor;"

Section 1.677(a)-1(d) of the Treasury Regulations on income tax (1954 Code) provides:

> "Under Section 677 a grantor is, in general, treated as owner of a portion of a trust whose income is, or in the discretion of the grantor or a non-adverse party, or both, may be applied in discharge of a legal obligation of the grantor."

Petitioners contend that § 677 has no relevance and that we should look only to § 61 of the 1954 Code which provides, in effect, that gross income means all income from whatever source derived, including but not limited to fifteen specifically designated items.

We agree with the Commissioner that § 677, supra, must first be applied in determining whether as a result of the transaction petitioners derived income which is within the ambit of § 61, supra. We are of the view that, inasmuch as the income from the trust was applied by a non-adverse party (the trustee) in discharge of the grantors' primary obligation to pay the gift tax, the grantors must be treated as owners of that portion of the trust for income tax purposes. To us this holding is in accordance with the explicit provision of § 677, supra, and the applicable regulations and is consistent with judicial decisions which in our view are analogous in principle.

In *Douglas* v. *Willcutts*, 296 U.S. 1 (1935), a husband created a trust which became part of a divorce decree and which provided for full settlement of alimony in favor of his divorced wife. The Supreme Court, applying the forerunners of the statutes here involved, held that income

from the trust was income taxable to the husband since it was used in discharge of his general obligation to support.

Helvering v. *Blumenthal*, 296 U.S. 552 (1935), reversing 76 F. 2d 507 (1935), furnishes additional support for the Commissioner's position. There, a settlor irrevocably transferred approximately $300,000 worth of stock in trust upon condition that the trust pay out of dividends received on the stock, a $33,000 demand note of the settlor held by a bank and secured by pledge of the stock which was the subject of the trust. Relying in part upon the bank's custom of selling the stock before seeking to enforce payment by the obligor, the Second Circuit held that the settlor was not liable for income tax on the dividends, stating:

> "The effect of transferring this stock, subject to the debt, was to make the stock the primary fund to meet the obligation and to place the petitioner [settlor] in the relation of surety only. Petitioner [settlor] was not enriched in any way by the payment of the note," 76 F. 2d at 508.

In a per curiam opinion and on the authority of *Douglas* v. *Willcutts*, *supra*, 296 U.S. 1, the Supreme Court reversed the Second Circuit.

We also regard *Staley* v. *Commissioner*, 5 Cir., 136 F. 2d 368 (1943), cert. denied, 320 U.S. 786 (1943), as persuasive authority against the contentions asserted by petitioners. In *Staley*, the taxpayer created five trusts by gift, expressly reserving the first $30,000.00 of income from each trust. This amount, or a total of $150,000, was paid to the taxpayer. Although the trust agreements did not explicitly provide the purpose for which the income was being reserved, it is apparent that the purpose of the reservation was to provide the amount necessary to discharge the taxpayer's gift tax obligation and that the taxpayer actually used the amount reserved for that purpose. Indeed,

the Fifth Circuit, in holding the amount reserved as taxable income of the donors, stated that the gift:

> "* * * was intended to be, and actually was, a gift of the entire corpus and of all the income except an amount necessary to assist in paying the gift taxes. Expressed differently, it was an outright transfer for no consideration; but with a reservation to the donor of a portion of the income." 136 F. 2d 369, 370.

See also, *Helvering* v. *Stuart*, 317 U.S. 154 (1942), modified 317 U.S. 602 (1942), and *Loeb* v. *Commissioner*, 7 Cir., 159 F. 2d 549 (1946).

Petitioners would, in effect, have us ignore the basic fact that the transfer in this case was made in *trust*. The cases cited by petitioners that involved trusts, such as *Edwards* v. *Greenwald*, 5 Cir., 217 F. 2d 632 (1954) and *David Keith*, 45 B.T.A. 644 (1941), are factually distinguishable. We have also accorded due consideration to *Estate of Morgan*, 37 T.C. 981 (1962), decided by the Tax Court since its decision in this case. We do not regard *Morgan* as controlling or dispositive of the issues presented herein.[4]

In summary, the donors here transferred property as a gift in trust in 1954; became primarily liable for the payment of the federal gift tax; gave the trustee discretionary power to use trust income to satisfy this obligation; had their gift tax obligation discharged by March 15, 1955, partially with the 1954 and 1955 trust income, before any other party became liable for the gift tax payment; and thus, within the meaning of the law, became the owners of a portion of the trust for income tax purposes.

Although the factual circumstances and the statutes involved in *Griffiths* v. *Commissioner*, 308 U.S. 355 (1939), were entirely different from those in the instant case, we

---

[4] We are advised that the Commissioner has appealed the decision in the *Morgan* case to the Court of Appeals for the Sixth Circuit.

believe that some of the language used by the Supreme Court in that opinion is particularly apropos here.

> "We cannot too often reiterate that 'taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid.' • • • And it makes no difference that such 'command' may be exercised through specific retention of legal title or the creation of a new equitable but controlled interest, or the maintenance of effective benefit through the interpostion of a subservient agency. • • • 'A given result at the end of a straight path' • • • 'is not made a different result because reached by following a devious path.' Legislative words are not inert, and derive vitality from the obvious purposes at which they are aimed, • • •. Taxes cannot be escaped 'by anticipatory arrangements and contracts however skillfully devised . . . by which the fruits are attributed to a different tree from that on which they grew.'" 308 U.S. at 357, 358.

What the trustee received as trust income and applied to payment of the gift tax, the Sheaffers in reality constructively received, and on that the petitioners must be taxed.

The decision of the Tax Court is

Affirmed.

A true copy.

Attest:

Clerk, U. S. Court of Appeals, Eighth Circuit.

APPENDIX C

Judgment

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 17,075. September Term, 1962.

ESTATE OF CRAIG R. SHEAFFER, Deceased, WALTER A. SHEAFFER, II, and JOHN D. SHEAFFER, Executors, and VIRGINIA D. SHEAFFER, *Petitioners*,

vs.

COMMISSIONER OF INTERNAL REVENUE.

On Petition for Review of Decision of The Tax Court of the United States.

This cause came on to be heard on the petition to review the decision of The Tax Court of the United States entered December 13th, 1961, determining that there are deficiencies in the income taxes against petitioners for the calendar years 1954 and 1955, and was argued by counsel.

On Consideration Whereof, It is now here Ordered and Adjudged by this Court that the decision of The Tax Court in this cause be, and the same is hereby, affirmed.

And it is further Ordered by this Court that the petition to review in this cause be, and it is hereby, dismissed.

February 13, 1963.

Order entered on Opinion:

Clerk, U. S. Court of Appeals,
Eighth Circuit.

APPENDIX D

Statutes and Regulations Involved

The Internal Revenue Code of 1939, 53 Stat. 1, is applicable to the gift tax in this case. The Internal Revenue Code of 1954, 68A Stat. 1, is applicable to the income tax in this case.

The relevant provisions of the Internal Revenue Code of 1939 are as follows:

"Sec. 1000. Imposition of Tax

"(a) For the calendar year 1940 and each calendar year thereafter a tax, computed as provided in section 1001, shall be imposed upon the transfer during such calendar year by any individual, resident or nonresident, of property by gift.

* * * * * *

"Sec. 1008. Payment of Tax

"(a) Time of Payment.—The tax imposed by this chapter shall be paid by the donor on or before the 15th day of March following the close of the calendar year.

* * * * *

"Sec. 1009. Lien for Tax

"The tax imposed by this chapter shall be a lien upon all gifts made during the calendar year, for ten years from the time the gifts are made. If the tax is not paid when due, the donee of any gift shall be personally liable for such tax to the extent of the value of such gift. Any part of the property comprised in the gift sold by the donee to a bona fide purchaser for an adequate and full consideration in money or money's worth shall be divested of the lien herein imposed and the lien, to the extent of the value of such gift, shall attach to all the property of the donee, (including after-acquired property) except any part sold to a bona fide

purchaser for an adequate and full consideration in money or money's worth. If the Commissioner is satisfied that the tax liability has been fully discharged or provided for, he may, under regulations prescribed by him with the approval of the Secretary, issue his certificate, releasing any or all of the property from the lien herein imposed.

The relevant provisions of the Internal Revenue Code of 1954 are as follows:

SEC. 61. GROSS INCOME DEFINED.

(a) GENERAL DEFINITION.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

SEC. 677. INCOME FOR BENEFIT OF GRANTOR.

(a) GENERAL RULE.—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—

(1) distributed to the grantor;

(2) held or accumulated for future distribution to the grantor; or

(3) applied to the payment of premiums on policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for a purpose specified in section 170 (c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

The relevant regulations are as follows:

Treasury Regulations 108 (1939 Code)

"Sec. 86.1. IMPOSITION OF TAX

"The statute imposes no tax upon property, but subjects to tax transfers of property by gift.

* * * * * * * * * *

"Sec. 86.2. TRANSFERS REACHED

"(a) In general.—. . . Various statutory provisions, which exempt bonds, notes, bills and certificates of the indebtedness of the Federal Government or its agencies and the interest thereon from taxation, are not applicable to the gift tax since this tax is an excise tax on the transfer, and is not a tax on the subject of the gift.

"Sec. 86.3. CESSATION OF DONOR'S DOMINION AND CONTROL

"The tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not be known or ascertainable.

* * * * * * * * * *

"Sec. 86.34. DONOR LIABLE FOR TAX

"The statute provides that the donor shall pay the tax . . . As to the personal liability of the donee, see section 86.35, and as to that of the executor or administrator, see section 86.70.

* * * * * * * * * *

"Sec. 86.35. LIEN FOR TAX

"A lien attaches upon all gifts made during the calendar year for the amount of the tax imposed upon the gifts made

during such year. The lien extends for a period of 10 years from the time the gifts were made, unless the tax is sooner paid. If the tax is not paid when due, the donee of any gift becomes personally liable for the tax to the extent of the value of his gift."

* * * * * * * * * * *

Treasury Income Tax Regulations (1954 Code)

"Reg. § 1.677(a)-1. INCOME FOR BENEFIT OF GRANTOR; GENERAL RULE.

(a) Section 677 deals with situations in which a grantor of a trust is treated as the owner of a portion of the trust because he has retained an interest in the income from that portion. See section 671 and §§ 1.671-2 and 1.671-3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

"(b) Under section 677, the grantor is treated in any taxable year as the owner of a portion of a trust (whether or not he is treated as an owner under section 674) of which the income for the taxable year or for a period not coming within the exception described in paragraph (e) of this section is, or in the discretion of the grantor or a nonadverse party, or both, (without the approval or consent of any adverse party) may be—

"(1) Distributed to the grantor;

"(2) Held or accumulated for future distribution to the grantor; or

"(3) Applied to the payment of premiums on policies of insurance on the life of the grantor, except policies of insurance irrevocably payable for a charitable purpose specified in section 170(c).

* * * * * * * * * * *

"(d) Under section 677 a grantor is, in general treated as owner of a portion of a trust whose income is, or in the

discretion of the grantor or a nonadverse party, or both may be, applied in discharge of a legal obligation of the grantor. However, see § 1.677(b)-1 for special rules for trusts whose income may not be applied for the discharge of any legal obligation of the grantor other than the support or maintenance of a beneficiary whom the grantor is legally obligated to support."

APPENDIX E

ESTATE OF ANNETTE S. MORGAN, Deceased, WILLIAM N. MORGAN, Executor v. COMMISSIONER.

Docket No. 88298. 37 TC 981, No. 95.

Filed February 21, 1962.

* * * * * * * * * * * *

Howard M. Kohn, Esq., and C. W. Landefeld, Esq., for the petitioner.

Buckley D. Sowards, Esq., for the respondent.

FAY, Judge: The Commissioner determined deficiencies in income tax of the decedent for the years 1957 and 1958 in the amounts of $13,238.26 and $26,686.82, respectively. The only issue for decision is whether certain income of trusts created by the decedent is taxable to her.

FINDINGS OF FACT

Most of the facts are stipulated and are found as stipulated.

The decedent resided during the taxable years in question in the City of Cleveland, Ohio. She filed timely Federal income tax returns for these years with the district director of internal revenue at Cleveland.

On October 18, 1955, the decedent created certain irrevocable trusts in favor of her issue consisting of 41,600 shares of stock in The Morgan Engineering Company, hereinafter referred to as the Morgan stock. The stock at that time had a value of approximately $1,000,000. The decedent's son, William H. Morgan, and her attorney, Robert S. Pflueger, were made trustees.

The trust agreement imposed upon the trustees the duty of paying the gift taxes incurred in connection with the gift and contained the following language relative thereto:

> The parties hereto expressly agree that the trustees shall pay any and all gift and/or other taxes occasioned

by the transfer herein, and that the stock is transferred subject to the trustee's obligation to pay all such taxes. The trustees shall make all necessary arrangements for and attend to the payment of all said taxes, and may raise funds for such purpose by selling a portion of the transferred stock and/or by borrowing, the decision to sell stock and/or to borrow to be made in accordance with the sole discretion of the trustees. In the event the trustees decide to borrow money to pay said taxes, they are hereby authorized to borrow money from any source and pledge any part or all of the assets herein transferred, and to repay such borrowings using for such purpose any funds in their possession.

The trust instrument also contained the following language with regard to holdings of the Morgan stock by the trust:

> The settlor requests the trustees, although no duty is imposed on them in this regard, to retain as an investment of the trusts created by this instrument the common stock of the Morgan Engineering Company originally placed in the trusts hereunder, and the common stock or other securities of any concern which shall succeed to the whole or a substantial part of the assets or business of the Morgan Engineering Company, even though such an amount of securities of one company may not be considered suitable as an investment by trustees. Furthermore, if at any time there are trust funds to be invested, the settlor requests the trustees, although no duty is imposed on them in this regard, to purchase, if available, and retain as an investment of the trusts created hereunder the common stock of The Morgan Engineering Company and the common stock or other securities of any concern which shall succeed to the whole or a substantial part of the assets or business of The Morgan Engineering Company.

This language was included to protect the trustees from any charge of negligence which might arise from their continued holding of the Morgan stock, which stock was not listed on any stock exchange.

The decedent incurred a Federal gift tax in the amount of $186,664.86 for the year 1955 by reason of the transfer in trust. This gift tax was calculated by using as the amount of the gift the value of the stock given, less the amount that would be required to pay the Federal gift tax on the transfer. The decedent filed a gift tax return with the district director of internal revenue at Cleveland, Ohio, reflecting a gift tax of $186,664.86. On or about April 16, 1956, William H. Morgan, acting as trustee, arranged for a loan from The Philadelphia National Bank in the same amount as the gift tax determined to be due. The loan was made to the trustees who signed a note which was guaranteed by William H. Morgan, personally. The 41,600 shares of Morgan stock were pledged as security for the loan. The decedent had no contact with the bank in connection with the arrangement or payment of this loan and was not liable for its payment. In 1956 the trustees paid the gift tax with the proceeds of the loan. The decision to obtain the money to pay the gift tax by borrowing was made by the trustees, and the decedent took no part in making such decision.

Payments were made on the loan by the trustees from the dividends on the Morgan stock. In 1957 the trustees paid the bank $8,770.32 in interest on the loan and repaid $21,664.86 of the principal. In 1958 they paid $7,318.95 in interest and repaid $40,000 of the principal.

The Commissioner determined that the amounts paid to the bank with respect to the loan in 1957 and 1958 should be included in the income of the decedent.

The decedent received no benefit from the fact that the money to pay her gift tax was obtained by borrowing rather than by selling a part of the trust corpus.

OPINION

The respondent contends that the payments made on the loan obtained to pay the decedent's gift tax were in substance payments of the decedent's legal obligation and are therefore taxable to her under section 677(a) of the Internal Revenue Code of 1954.[1]

This Court has recently held that income of a trust used to pay the settlor's gift tax liability is taxable to the settlor. *Craig R. Sheaffer* [Dec. 25,f00], 37 T. C.—(October 31, 1961). However, in the present case the trustees had paid the gift tax of the settlor in 1956, a year prior to the taxable years before the Court. The parties have stipulated that the amount of the gift tax equalled the amount paid. Therefore, the trustees' discretion to use income of the trust to pay the decedent's gift tax was extinguished in 1956. It is not argued that the trustees could have used income from the trusts for the benefit of the decedent in

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[1] SEC. 677. INCOME FOR BENEFIT OF GRANTOR.

(a) General Rule.—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or in the discretion of the grantor or a nonadverse party, may be—

(1) distributed to the grantor;

(2) held or accumulated for future distribution to the grantor; or

(3) applied to the payment of premiums on policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

any manner after 1956 unless repayment of the sums borrowed by the trustees may be considered such a payment.

The respondent argues that repayment of this loan does constitute payment by the trust of the decedent's legal obligation because the substance of the transaction is that the income of the trust res was used to pay the decedent's gift tax. In support of this contention the respondent cites *Clifton B. Russell* [Dec. 14,797], 5 T. C. 974 (1945), appeal dismissed 154 F. 2d 829 (C. A. 1, 1946). In the *Russell* case the settlor established an irrevocable trust in certain stock which he held outright and in his equity in other stock which was pledged for his personal debt of $25,000. The trustee was authorized to pay the debt for which this stock was pledged. The trustee borrowed $20,000 from the settlor and used this sum, together with $5,000 of income of the trust, to discharge the debt in 1940. The trustee made payments on the loan from the settlor in 1940 and 1941 out of the income of the trust. This Court held the substance of the transaction was that the income of the trust was used to pay the personal obligation of the settlor and that this could have been done without the consent of an adverse party. Therefore, the amount of the payments made to the settlor on the loan was held taxable to him. That case is distinguishable from the present case. In *Russell* the loan was made between related parties—the settlor and the trustee. In the present case the loan was an arm's length transaction with an independent party—the bank, and the settlor took no part in the transaction. Further, in *Russell* the income of the trust was paid to the settlor in satisfaction of his loan. In the present case the decedent's interest in the property of the trust terminated immediately upon the payment of the gift tax.

Section 677(a) of the Internal Revenue Code of 1954, *supra*, clearly evidences a Congressional intent that a settlor of a trust, in order to avoid tax on the income of the trust property, must receive no benefit from the income of the property without the consent of an "adverse party." Fur-

thermore, it is clear that we should not allow the taxpayer to accomplish indirectly what Congress has prohibited. On the surface this transaction appears to be but an indirect method for diverting the income of the trust property to the decedent. It appears that income of the trust property was anticipated by obtaining the loan, the proceeds of which were given to the decedent. The loan was then repaid from the income of the trust as it was realized.

Upon analysis, however, this illusion disappears. Surely had the decedent sold a sufficient amount of the Morgan stock to pay the gift tax and given the remainder to the trust, she would not be subject to tax on any part of the trust income. The result would be the same if the stock had been given to the trustees and they had then sold a portion to pay the tax, at least in years after the gift tax was paid. Did the decedent then receive any monetary benefit from the method of which the trustees chose to discharge the trust obligation to pay the gift tax? Her gift tax obligation was paid when due and that is the sole benefit she would have received no matter what method had been chosen by the trustees to obtain funds for this purpose. The manner of obtaining the money was chosen independently by the trustees who were authorized to select whatever method they deemed advisable. Of course, the fact that the trustees chose to obtain money by borrowing and then repaying the loan from income means that the trust retained more corpus and less income. This however, did not benefit the decedent because she retained no interest in the trust and could not recover the corpus. Therefore, since the decedent received no benefit from the fact that the trustees borrowed to discharge her gift tax obligation and repaid the loan from trust income, she cannot be held to have constructively received the income used to repay the loan.

This case, therefore, is controlled by our decision in *David Keith* [Dec. 12,157], 45 B. T. A. 644 (1941), acq. 1942-1 *C. B.* 10, a case which arose under section 167 of the Reve-

nue Acts of 1936 and 1938, which section was a predecessor of section 677(a) of the 1954 Code. In that case, which involved a trust established in 1926, the trustees had been authorized to sell property and/or to borrow money to pay certain debts of one of the settlors. They acquired the funds to pay the debts by both selling property and borrowing. By the end of 1930 both the debts of the settlor and the debts which the trustees incurred to pay them had been discharged. In 1931 and each year thereafter the trustees accumulated income in a sinking fund pursuant to the trust instrument to replace that portion of corpus that had been used to pay the settlor's debts. In holding the accumulated income not taxable to the settlor, we said:

> Whatever may have been said in 1926-1930 as to the propriety of attributing to petitioner the trust income used to discharge his debts, there is no theory upon which the income of succeeding years may be attributed to him. It was not subject to his control or demand and was not used for his benefit to discharge any of his obligations. His obligations had been paid in 1930 and no continuing obligation was left upon him. Thereafter, except as to the distributable shares, the trust income was taxable to the trust.

The same considerations apply in the present case.

Reviewed by the Court.

Decision will be entered for the petitioner.

TIETJENS, Judge, dissenting: The gift tax was the primary obligation of the settlor. Had the income of the trust been used directly to pay the gift tax, such payment would have been taxable income to the settlor. *Craig R. Sheaffer* [Dec. 25,100], 37 T. C.—(No. 13). Here the trustees took a roundabout method. They first borrowed money with which they paid the gift tax and then repaid the loan from trust income. It seems to me that the substance of the transactions is the same in both cases, i.e., the liability of

the settlor is discharged by income from the trust. In either case the settlor should be taxed on the trust income. *Clifton B. Russell* [Dec. 14,797], 5 T. C. 974.

TURNER and RAUM, Judges, agree with this dissent.

* * * * * * * * * *

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

v.

ESTATE OF ANNETTE S. MORGAN, Deceased, WILLIAM H. MORGAN, Executor, *Respondent*.

U.S. Court of Appeals, Sixth Circuit, No. 15,099, Apr. 10, 1963.

37 TC 981 (Opinion by FAY, J.) affirmed. Years 1957-1958. Decision for taxpayer.

Carolyn R. Just, Atty.; On brief: Louis F. Oberdorfer, Asst. Atty. Gen., Lee A. Jackson, Robert N. Anderson, Attys., Dept. of Justice, Wash. 25, D.C., for Petitioner.

Howard M. Kohn; On brief: C. W. Landefeld; Of counsel: Grossman, Schlesinger and Carter. 1401 The East Ohio Bldg., Cleveland 14, Ohio, Attys. for Respondent.

ORDER

Before MCALLISTER and O'SULLIVAN, Circuit Judges, and WILLIAM E. MILLER, District Judge.

This cause coming on to be heard upon the petition for review of the decision of the Tax Court of the United States, and the court having considered the briefs, oral argument of counsel, and the entire record,

Now, therefore, it is Ordered, Adjudged and Decreed that the decision of the Tax Court be and is hereby affirmed on its Findings of Fact and Opinion, reported at 37 T.C. 981.

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In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 183

WALTER A. SHEAFFER, II, AND JOHN D. SHEAFFER, Executors of the Estate of Craig R. Sheaffer, Deceased, and VIRGINIA D. SHEAFFER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (Pet. 1a-13a) is reported at 37 T.C. 99. The opinion of the court of appeals (Pet. 14a-23a) is reported at 313 F.2d 738.

JURISDICTION

The judgment of the court of appeals was entered on February 13, 1963. (Pet. 24a.) A petition for re-

hearing was denied on March 6, 1963. (Pet. 2.) The petition for a writ of certiorari was filed on June 3, 1963. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

Whether the grantor is taxable, under § 677 of the Internal Revenue Code of 1954, on the income of a trust used to pay the gift taxes on the transfer to the trust or to repay amounts borrowed by the trust earlier in the same year to pay the gift taxes.

STATUTES AND REGULATIONS INVOLVED

Sections 1000(a), 1008(a), and 1009 of the Internal Revenue Code of 1939; § 677(a) of the Internal Revenue Code of 1954; §§ 86.1 and 86.3 of Treasury Regulations 108 (1939 Code); and § 1.677(a)-1 of Treasury Regulations on Income Tax (1954 Code) are set forth in relevant part in the Appendix, pp. 9-11, *infra*.

STATEMENT

On February 2, 1954, petitioner Virginia D. Sheaffer [1] transferred stock valued at $1,715,000 in trust

[1] Craig R. Sheaffer, her husband, consented to have the gift treated as made one-half by him for gift tax purposes (see § 1000(f), Internal Revenue Code of 1939) and also filed joint income tax returns with his wife for the years involved. It is only for that reason that the executors of his estate are parties, and for simplicity we will refer to Virginia as the sole grantor and taxpayer.

for her children. The trust agreement with the corporate trustee provided that:

> The trustee agrees that, to the full extent of the value of the corpus of the trust estate and the income therefrom, it will assume and pay all federal and state gift taxes * * * which shall * * * become due from any one by reason of the transfer [of the stock to it] * * *. The trustee is authorized and agrees to obtain a loan in an amount sufficient to pay all such taxes and to pledge or otherwise to apply such part or all of the corpus and income of the trust estate, and to take such other action, as shall be required or deemed advisable by the trustee in order to secure the loan. The trustee agrees to apply the proceeds of such loan in payment of such taxes.

The gift tax due on the transfer, computed on the net value of the gift after deducting the trustee's assumed obligation to pay the gift tax, was $327,307.[2] The trustee paid the tax on March 14, 1955, one day prior to the due date of the returns. The funds used to pay the tax consisted of $188,607 of accumulated trust income plus $138,700 borrowed by the trustee on the security of the trust assets (Pet. 2a-5a).

The trust received dividends on the contributed stock totalling $140,000 in 1954 and $115,500 in

---

[2] In years subsequent to those involved here, the Commissioner determined that the value of the shares was somewhat higher than reported ($1,845,701) and determined a deficiency that was duly paid by the trust (Pet. 6a), but that does not affect the issues presented here.

1955 (Pet. 6a-7a). The Commissioner held the dividends taxable to the grantor under § 677 of the Internal Revenue Code of 1954, on the ground that the trust income had been used for her benefit by paying the gift taxes for which she was primarily liable. The Tax Court upheld the deficiencies (Pet. 1a-13a), and the court of appeals affirmed its decision (Pet. 14a-23a).

ARGUMENT

1. Taxpayer does not deny that she would be taxable on the income of the trust if, instead of directing payment of the gift taxes, the trust instrument had simply directed the trustee to pay such income directly to her on March 14, 1955. Her sole argument is that the trust's payment of the gift taxes was not equivalent to a cash distribution to her. The question, therefore, is whether a donee's payment, pursuant to a contract with the donor, of the gift tax on the gift is a "receipt" by the donor of the amount so paid.

The gift tax is a tax on the donor's transfer, not the donee's receipt, of property. Not only is the tax measured by the donor's total gifts (to determine exemptions and rates), but the Code expressly provides that the gift tax "shall be paid by the donor on or before" March 15 (§ 1008(a)). The donee has no duty to pay the tax on the due date and becomes "personally liable" only "If the tax is not paid when due" (§ 1009)—in short, only if the donor is in default. The regulations thus correctly conclude that the gift tax "is a primary and personal liability

of the donor" and is "an excise upon his act of making the transfer." Treas. Regs. 108, § 86.3. See *Mississippi Valley Trust Co.* v. *Commissioner*, 147 F. 2d 186 (C.A. 8); *Fletcher Trust Co.* v. *Commissioner*, 141 F. 2d 36 (C.A. 7), certiorari denied, 323 U.S. 711.

The tax being the primary obligation of the donor, it follows from settled principles that the bargained-for contractual undertaking by another to pay it results in a constructive receipt by the donor of the amount paid. *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716 (employer's payment of employee's income tax), holds at least that much. See also *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (creditor's forgiveness of indebtedness); *Douglas* v. *Willcuts*, 296 U.S. 1 (trust's satisfaction of grantor's support obligations); *Helvering* v. *Blumenthal*, 296 U.S. 552 (trust's payment of grantor's debt).

Taxpayer argues however, that that doctrine is subject to two limitations which render it inapplicable here. First, she contends that the payment of a liability by an obligor does not give rise to a taxable receipt by a co-obligor, even though the latter may be primarily liable (Pet. 12-13). The only case she cites which even arguably supports that proposition[3]

[3] Two other cases cited by petitioner, *Tucker* v. *Commissioner*, 226 F. 2d 177 (C.A. 8), and *Commissioner* v. *Hopkinson*, 126 F. 2d 406 (C.A. 2), are wholly inapposite. In *Tucker*, the payments sought to be imputed to the taxpayer as a constructive dividend did not discharge any legal obligation of his, and whatever benefit, if any, they may have conferred upon him was an entirely incidental aspect of a transaction whose sole purpose was to benefit the corpora-

is a prior decision of the Eighth Circuit itself, *Ruben* v. *Commissioner*, 97 F. 2d 926)—a case which the same court did not deem dispositive here (Pet. 17a) and which plainly cannot serve as the basis for a conflict.

Second, it is urged that the satisfaction of a taxpayer's legal obligation does not give him taxable income where the indebtedness was gratuitously incurred (Pet. 13-15). Whatever validity that proposition may have—and we concede it none—in the case of a truly gratuitous indebtedness, it has no application in the instant case. Here, the discharged obligation was not gratuitously assumed by the taxpayer but was a tax liability imposed upon her by law. Payment of such an obligation by a third person clearly gives rise to a taxable receipt. *Old Colony Trust Co.* v. *Commissioner*, *supra*.

2. Taxpayer is mistaken in asserting a conflict between the decision below and that of the Sixth Circuit in *Commissioner* v. *Morgan's Estate*, 316 F. 2d 238, affirming, *per curiam*, 37 T.C. 981 (Pet. 31a-38a). There certain stock was transferred in trust in 1955 with instructions that the trustees pay the gift tax, either by borrowing money or selling stock. In 1956, the trustees paid the gift tax with funds borrowed from a bank, and in 1957 and 1958

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tion. In *Hopkinson*, the Commissioner sought to tax the beneficiary of a trust on amounts paid by the trust as fees for legal services allegedly rendered the taxpayer. The court exonerated the taxpayer from liability expressly on the ground that the legal services in question had not been rendered to her but to the trustee, and hence the payment of the fees did not discharge any obligation of hers.

applied current trust income to the repayment of the loan. The Tax Court rejected the Commissioner's contention that the income so applied was taxable to the grantor in 1957 and 1958, and the Sixth Circuit affirmed on the Tax Court's findings and opinion. Since the Tax Court decided *Morgan* for the taxpayer less than four months after it decided *Sheaffer* for the Commissioner, and the two appellate decisions both affirmed the Tax Court, it would be surprising indeed to find them in conflict. The distinction drawn by the Tax Court in *Morgan* was this: whereas in *Sheaffer* trust income was used to discharge the settlor's gift tax liability in the taxable year in question, in *Morgan* that liability had been discharged, and the trustee's discretion to apply income for the settlor's benefit had been extinguished, before the controverted taxable years had even opened. This distinction apparently commended itself to the Sixth Circuit, which adopted the findings and opinion of the Tax Court, and also (though less clearly) to the court below, which observed (Pet. 22a) that it did not regard the Tax Court's *Morgan* decision "as controlling or dispositive of the issues presented herein."

Taxpayer points out that while most of the income sought to be taxed ($188,607.04) was applied directly to the payment of the gift tax, a portion of it ($66,892.96), like the income in *Morgan*, was received by the trust subsequent to the gift tax payment and used to repay the loan. The fact remains, however, that here, unlike in *Morgan*, (a) the taxpayers constructively received benefits from the trust in the very taxable year at issue (1955); and (b) all income

sought to be taxed, including the "after-received" income, had been received by the trust prior to the close of that same taxable year.

We note additionally that neither in this Court nor in the court of appeals did the taxpayer here advance the argument which carried the day for the taxpayer in *Morgan*; at no point has she suggested that the after-received income used to repay the loan should be treated differently from the accumulated income used to pay the gift tax itself. Her contention, rather, is that, regardless of the character (income or principal) of the trust funds used, the satisfaction of a settlor's gift tax liability by the donee trust does not give rise to a taxable receipt by the settlor. On that issue—the only one raised here—the Sixth and Eighth Circuits are plainly in agreement, both rejecting the taxpayers' position.

CONCLUSION

For the reasons stated, the petition should be denied.

Respectfully submitted,

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JULY 1963.

APPENDIX

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

SEC. 1000. IMPOSITION OF TAX.

(a) For the calendar year 1940 and each calendar year thereafter a tax, computed as provided in section 1001, shall be imposed upon the transfer during such calendar year by any individual, resident or nonresident, of property by gift. * * *.

SEC. 1008. PAYMENT OF TAX.

(a) *Time of Payment.*—The tax imposed by this chapter shall be paid by the donor on or before the 15th day of March following the close of the calendar year.

* * * * * *

SEC. 1009. LIEN FOR TAX.

The tax imposed by this chapter shall be a lien upon all gifts made during the calendar year, for ten years from the time the gifts are made. If the tax is not paid when due, the donee of any gift shall be personally liable for such tax to the extent of the value of such gift. * * *

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

SEC. 677. INCOME FOR BENEFIT OF GRANTOR.

(a) *General Rule.*—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the dis-

cretion of the grantor or a nonadverse party, or both, may be—

(1) distributed to the grantor;

(2) held or accumulated for future distribution to the grantor; or

(3) applied to the payment of premiums on policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

* * * *

Treasury Regulations 108 (1939 Code):

SEC. 86.1 *Imposition of Tax.*—The statute imposes no tax upon property, but subjects to tax transfers of property by gift. * * *

* * * * *

SEC. 86.3 *Cessation of Donor's Dominion and Control.*—The tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability

of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

* * * *

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.677(a)-1 *Income for benefit of grantor; general rule.*

* * * * *

(d) Under section 677 a grantor is, in general, treated as owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor.

* * *

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1963

No. 183

WALTER A. SHEAFFER, II, ET AL.,
PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

REPLY BRIEF FOR PETITIONERS

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IN THE

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WALTER A. SHEAFFER, II, ET AL.,
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COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

REPLY BRIEF FOR PETITIONERS

---

1. It is possible to be misled by the Government's statement that the taxpayers have failed to make the argument which "carried the day" (Op. Br. 8) in *Commissioner* v. *Estate of Morgan*, 316 F.2nd 238 (6th Cir. 1963), affirming 37 T.C. 981 (1962). There is no justification for such a statement. The implication seems to be that the taxpayers have neglected to preserve in the Court below their right to argue for *Morgan* treatment of the $66,892.96 used here for loan

repayment.[1] Obviously that is not the case. It is a fact that we seek a complete reversal of the Court below, not just a partial victory. Nevertheless we point out here, as we did in the Court below, that the Commissioner has attacked the taxpayers on two fronts—income used to pay the gift tax, and subsequent income used to repay a loan; that attributing income to the taxpayers is less defensible on the one front than on the other; and that this case is more conspicuously in conflict with *Morgan* on the one front than on the other.

We pointed out these two aspects of this case and our attitude with respect to them on page 9 of our brief in the Court below when we said:

> "In this case the Tax Court did what it refused to do in two other cases by taxing the settlor on income used to repay a loan for which the settlor

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[1] The $327,307.04 gift tax was paid with the following classes of funds:

(a) $188,607.04 of trust income accumulated (1954 and 1955) prior to the time of the gift tax payment;

(b) $66,892.96 of borrowed money repaid with income received later in the same year (1955) after the gift tax was paid; and

(c) $71,807.04 of borrowed money repaid the next year (1956) with income of that year; this amount is not involved in this case but is in issue for the later year.

(b) and (c) are identical in principle with the *Morgan* facts and fit the test laid down by *Morgan* that the donor's interest in the property of the trust terminated immediately upon payment of the gift tax. Respondent would distinguish (b) from (c) in that in (b) the income accrued later in the same year that the gift tax was paid; while in (c) the income used to repay the loan accrued in a later year. The time element can only be of importance in determining whether at the time of payment of the gift tax, there was any accumulated income in the trust.

was not liable. Furthermore, the distinction between the use of income in payment of the settlor's debt on the one hand and the use of income to repay a loan which was incurred to pay the settlor's debt on the other hand seems unduly fine," citing *Morgan* and *Keith v. Commissioner*, 45 B.T.A. 644 (1941).

This contention was also made as Point No. 1 of the petition for rehearing in the Court below (See Appendix A).

The Government seems to say that if there is a partial inconsistency between *Sheaffer* and *Morgan*, these taxpayers should not have the benefit of it in the favorable exercise of this Court's discretion because of the taxpayers' assertion of a total inconsistency. No reason is advanced, nor is any apparent, why this should affect the Court's discretion.

2. It simply is not true that the Sixth Circuit has rejected our main contention regarding trust income applied to payment of gift tax, thus placing it "plainly in agreement" with the Eighth Circuit (Op. Br. 8). Of course the Eighth Circuit has rejected our contention. But the full Tax Court in *Morgan* did not reconsider the correctness of its single judge decision in *Sheaffer* (erroneously in our opinion) because of the difference between the cases. In affirming, the Sixth Circuit also avoided the issue.

3. The Government can have but little enthusiasm for its *new* role of reconciler of *Sheaffer* and *Morgan* on the grounds that in *Sheaffer*: (1) income of $188,607.04 was applied toward payment of the gift tax; and (2) income of $66,892.96 was, as in *Morgan*, received after the gift tax had been paid and applied

on repayment of a loan, but, unlike in *Morgan*, it was received before the end of the same taxable year in which the gift tax was paid.

The Government showed no indication of satisfaction with the first distinction when it said on page 30 of its *Sheaffer* brief before the Eighth Circuit:

> "The difficulty with the decision in the *Estate of Morgan* is that the substance of that transaction, as evidenced by what actually occurred, is that trust income of subsequent years could have been, and actually was, indirectly used by a nonadverse party for the benefit of the grantor.";

or when it said on page 6 of its brief in *Morgan* before the Sixth Circuit:

> "No different results should follow with respect to the grantor's taxability of trust income because of the intervention of the bank loan, obtained for her benefit."

The second distinction is indefensible, and the Government does not attempt to defend it except by trying to key the rationale of *Morgan* to the fact that the trustee's discretion "had been extinguished before the controverted taxable year had even opened" (Op. Br. 7). Such a test does not make sense. As the Tax Court put it in *Morgan* (Pet. 35a), "the decedent's [grantor's] interest in the property of the trust terminated immediately upon the payment of the gift tax."

4. The Government now seems to agree with us that standards of constructive receipt are the same in trust and non-trust cases, but now apparently contends that a donee's payment of gift tax is necessarily income

to the donor (Op. Br. 5-6).[2] There are situations where the payment of a person's tax liabilities by another constitutes income. The relationship of the parties may signify that the only theory on which one person can be paying the debts of another is in terms of a taxable transaction such as salary (*Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 [1929]), or rent (*United States* v. *Boston & Maine R. Co.*, 279 U.S. 732 [1929]). But the donee of a gift is no interloper with respect to the gift tax. He is the person for whose benefit the donor gratuitously incurs a tax liability, just as the donors in *Edwards* v. *Greenwald*, 217 F. 2d 632 (5th Cir. 1954) (quoted Pet. 14-15), gratuitously incurred another kind of liability for the benefit of their donees. He (the donee) and the gift he received are also liable for satisfaction of the tax obligation. His interest in the tax is every bit as close as the donor's.

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[2] In citing *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (Op. Br. 6), in support of his attempted answer to our claim that income does not arise from discharge of an obligation gratuitously incurred, respondent overlooks what this Court said on page 729:

> "The payment of the tax by the employer was in consideration of the services rendered by the employee and was a gain derived by the employee from his labor."

The Court then continues on page 730:

> "Nor can it be argued that the payment of the tax in No. 130 was a *gift*. The payment for services, even though entirely voluntary, was nevertheless *compensation within the statute*." (Emphasis supplied.)

In the instant case, there was no "compensation" for services, and there was "a gift"; the obligation to pay the gift tax was gratuitously incurred by donor on condition that the donee assume and pay that same obligation. In *Sheaffer*, both donor and donee incurred the same amount of liability on the same date—the date of gift, February 2, 1954—although different dates were fixed by the federal collection statutes as to when the liability of each would ripen into an obligation to pay.

5. The Government suggests (Op. Br. 6) that it would be inappropriate for this Court to grant *certiorari* to resolve a conflict between the Eighth Circuit's decision in this case and the same Court's holding in *Ruben* v. *Commissioner*, 97 F. 2d 926 (8th Cir. 1938). We do not ask the Court to do so. We simply cite *Ruben* and analogous cases as correct statements of the law that should have been applied to this case.

6. The Government's citation of *Mississippi Valley Trust Co.* v. *Commissioner*, 147 F. 2d 186 (8th Cir. 1945) (Op. Br. 5) as standing for the proposition that the donor's gift tax liability is "primary" as between himself and the donee is inexplicable in view of that Court's statement:

> "Only in the sense that the tax is owing in the first instance from the donor, and that the liability of the donee does not arise unless the donor fails to make payment of the tax by the 15th day of March following the close of the calendar year, and that such liability on the part of the donee is limited to the extent of the value of the gift, can the donee's liability be said to be secondary or qualified. If the donor fails to pay the automatically imposed tax when due, in accordance with the statute, no matter what the reason for his failure, there is an immediate and direct liability on the donee for the legally owed tax, to the extent of the value of the gift." 147 F. 2d 186, 187-8.

CONCLUSION

In the aftermath of the Sixth and Eighth Circuit decisions tax lawyers and trust companies are in a state of frustrated confusion and some of their clients may be receiving bad advice.[3] Only a decision of this Court can illuminate this area of the Internal Revenue law by recognizing the underlying realities in transactions like the one in this case.

Respectfully submitted,

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[3] See 7 Commerce Clearing House Standard Federal Tax Reporter, paragraph 8507 (July 17, 1963), which gives the dubious advice to practitioners that trustees should rely on the Government's asserted distinction between *Sheaffer* and *Morgan* and arrange to borrow money and pay their gift taxes if possible in a year before the year in which they will receive income; but then realistically concludes that this too will probably be challenged by the Government. (See Appendix B.)

APPENDIX A

Petition for Rehearing

Filed by petitioners in the Court below, *Estate of Craig R. Sheaffer, Deceased, et al. v. Commissioner*, No. 17,075, September Term, 1962.

(Copy of Point 1, at pages 2-3)

1. At three different places in its opinion (pages 4, 10 and 11) this Court has evidenced its misunderstanding of certain basic facts.

On page 4, the Court stated that the $115,500 in dividends received by the trustee in 1955 were applied by the trustee toward payment of the gift tax. In so stating it lost sight of the fact that dividends of only $52,500 were received by the trustee prior to March 14, 1955, the date of the payment of the gift tax. (See Pet. Br. 9, 28).

Again, on page 10, the Court recognized that the gift tax obligation was discharged "partially with the 1954 and 1955 trust income", but it failed to realize that less than one-half of the 1955 trust income could have been used for that purpose.

On page 11, the concluding sentence of the Court's opinion reads as follows:

> "What the trustee received as trust income and applied to payment of the gift tax, the Sheaffers in reality constructively received, and on that the petitioners must be taxed."

But this Court failed to realize that the Sheaffers would be taxed not only on dividends received and used in payment of the gift tax, but also on money borrowed by the trustee.

This Court, on page 10, in discussing *Estate of Morgan*, 37 T.C. 981 (1962), did "not regard *Morgan* as controlling or dispositive of the issues presented", in the *Sheaffer*

case. But the Court overlooked the fact that the basis for the *Morgan* decision was that the trust income there in issue was received *after* the gift tax was paid.

The effect of the Court's decision would be to tax to petitioners dividends received by the trustee *after*, as well as prior to, the date of payment of the gift tax.

APPENDIX B

Under date of July 17, 1963, after the petition herein was filed, Commerce Clearing House issued a bulletin (7 Standard Federal Tax Reporter, paragraph 8507) containing a discussion of the *Sheaffer* and *Morgan* decisions, concluding with the following paragraph:

> "Distinction Is Difficult
>
> "The distinction between the decisions is difficult to discern, especially since in *Morgan* the Tax Court said that the grantor's interest in the trust property terminated immediately upon payment of the gift taxes. If this be the key to the decision, it seems inconsistent with the holding in *Sheaffer* that dividends received by the trust in the same taxable year that the gift taxes were paid, but presumably received after the date on which the taxes were paid, were used for the grantor's benefit. Perhaps the real distinction lies in the fact that in one case income was actually received by the trust before, and during, the year in which the gift taxes were paid. In the other case, there was no question (or mention) of receipt of income by the trust, but of effect of payments made by the trust. The best tax procedure, then, under these decisions, is to require or have the trust borrow money to pay gift taxes, making sure not to repay the loan until a later year. However, one can well expect the Commissioner to again contest such procedure in the courts. Back reference ¶3749.1816."

We refer to this Bulletin to show this same uncertainty on the part of an organization as useful to, and as much

relied upon by, trust departments of banks and trust companies, and the legal profession in its tax practice, as is the Commerce Clearing House; and more important, to show a most serious error of C.C.H. in its recommendations concerning *Sheaffer* and *Morgan*. The next to the last sentence of the bulletin first recommends that "the trust borrow money to pay gift taxes * * *". This is sound advice under *Morgan* but bad advice under the Eighth Circuit *Sheaffer* decision on the $138,700.00 borrowed. (This borrowed amount included both the $66,892.96 of borrowed money repaid in 1955, see paragraph (b) of our footnote 1 (p. 2, *supra*), plus the $71,807.04 of borrowed money repaid in 1956, see paragraph (c) of same footnote.) C.C.H. then completes its recommendation with the admonition: "making sure not to repay the loan until a later year." That advice can only arise from the fears by C.C.H. of respondent's fanciful distinction as to the importance of the year of repayment.

C.C.H. is in effect telling each subscriber that he can set up a trust under which his client can make a gift in 1963. The trustee can borrow sufficient money prior to April 15, 1964, to pay the gift tax regardless of how much income has been accumulated in the trust prior to April 15, 1964, and no income taxes will be asserted against the grantor provided that no payments are made on the loan until 1965. But then C.C.H. withdraws this assurance in its final sentence,—possibly because of a realization of the true nature and full extent of the Commissioner's proposed restriction that the gift tax must be paid off before the taxable years had even opened.

In making this dubious recommendation, C.C.H. recognizes the true basis of the *Morgan* decision when it says, "in *Morgan* the Tax Court said that the grantor's interest in the trust property terminated immediately upon payment of the gift taxes." Nevertheless, C.C.H. declines to accept the rationale of the *Morgan* case simply because as stated, in the next sentence by C.C.H. "it seems inconsistent with the holding in *Sheaffer* * * *"